

DEPARTMENT OF THE TREASURY

Office of the Under Secretary for Domestic Finance

17 CFR Part 403

RIN 1505-AA42

Implementing Regulations for the Government Securities Act of 1986

AGENCY: Office of the Under Secretary for Domestic Finance, Treasury.

ACTION: Final rule.

SUMMARY: The Department of the Treasury ("Department") is issuing in final form amendments to the regulations issued under the Government Securities Act of 1986, as amended (the "Government Securities Act" or "GSA"). The amendments implement a buy-in requirement for mortgage-backed securities that are in a fail to receive status for more than 60 calendar days; and all government securities that are needed to complete a customer sell order (other than a short sale) if the securities have not been received from the customer within 30 calendar days after the settlement date for all government securities except mortgage-backed securities, or 60 calendar days after the settlement date for mortgage-backed securities. The final rule adopts without substantive change the buy-in requirements for mortgage-backed securities in a fail to receive status that were prescribed in the proposed rules published for comment on April 17, 1991. However, the time frames for buy-ins of customer sell orders have been revised in the final rule in response to comments received on the proposed rules. These requirements apply to all entities that are required to register or provide notice of their status as government securities brokers and dealers.

EFFECTIVE DATE: April 29, 1994.

FOR FURTHER INFORMATION CONTACT: Ken Papaj (Director), or Lee Grandy (Government Securities Specialist), Public Debt, Government Securities Regulations Staff, 999 E Street, NW., room 515, Washington, DC 20239-0001, (202) 219-3632. (TOD for hearing impaired: (202) 219-9274.)

SUPPLEMENTARY INFORMATION:

I. Background

The GSA regulations currently require a government securities broker or dealer to take prompt steps to obtain possession of control of customers' fully paid or excess margin securities that have been in a fail to receive status for more than 30 calendar days through

a buy-in procedure or otherwise. However, mortgage-backed securities are not subject to this buy-in requirement since the Department suspended the application of this rule to such securities in the GSA regulations that were issued in July 1987. In addition, the current GSA regulations do not impose a buy-in requirement for customer sell orders where the government securities broker or dealer has not obtained the securities from its customer. A temporary rule imposing such a requirement on registered government securities brokers and dealers was suspended in the July 1987 GSA regulations issued by the Department.

On April 17, 1991, the Department proposed for comment amendments to sections 403.1, 403.4, and 403.5 of the GSA regulations. The proposed amendments prescribed buy-in requirements for: (i) Mortgage-backed securities in a fail to receive status for more than 60 calendar days, and (ii) customer sell orders (other than short sales) in which the securities were not received from the customer within ten business days after the settlement date.

The proposed rule was intended to subject mortgage-backed securities to a 60 calendar day buy-in requirement, rather than the 30 calendar days applicable to other government securities due to the unique nature of the mortgage-backed market, particularly the lengthy settlement cycle. The reader is referred to the preamble to the proposed rule⁴ for a more detailed discussion of the Department's reasons for adopting a 60 calendar day time frame for buy-ins of mortgage-backed securities. The proposed rulemaking also included buy-in rules for customer sell orders that would apply to all government securities brokers and dealers, including financial institutions. Specifically, the provisions proposed that if a government securities broker or dealer executes a customer sell order (other than a short sale) and the broker or dealer has not obtained the securities from the customer within ten business days after the settlement date, then the broker or dealer would be required to close out the transaction with the customer by purchasing securities of like kind and quantity. The Department specifically requested comments concerning the appropriateness of the ten-day time frame.

The comment period for the proposed rules closed on June 17, 1991. Only one letter was received in response to the proposed rule changes. The commenter supported the 60-day buy-in time frame for mortgage-backed securities in a fail to receive status but opposed the proposed rule for customer sell orders. However, the commenter suggested modifications to the time frame for buy-ins of customer sell orders if Treasury decided to adopt such a rule.

Treasury did not issue these rules in final form prior to the expiration of its rulemaking authority on October 1, 1991. Treasury's authority under the GSA was permanently reauthorized on December 17, 1993, hence the long delay in finalizing these rules.

II. Section-by-Section Analysis of Proposed Changes

A. Buy-Ins for Fails To Receive

The Department is now adopting without significant change amendments to paragraphs 403.1, 403.4(g) and 403.5(c)(1)(iii) that were proposed in April 1991. These provisions would require all government securities brokers and dealers that are required to register or file notice pursuant to 15Cfa)(l) of the Exchange Act to take prompt steps to obtain possession or control of mortgage-backed securities that are in a fail to receive status for more than 60 calendar days through a buy-in procedure or otherwise. The Public Securities Association (PSA), which was the only commenter on the proposed rules, supported the 60 calendar day time frame for buy-ins of mortgage-backed securities, stating that the proposal is a reasonable approach." This time frame reflects the recommendations made in July 1989 by an industry-wide task force established by the PSA.

As discussed in more detail in the preamble to the proposed rules, the Department is adopting a longer buy-in time frame for fails to receive for mortgage-backed securities than the 30- calendar day time frame in place for other government securities. This longer time period is appropriate given the normally longer settlement cycle for mortgage-backed securities (which is often as long, as 30 days), the complexities of these instruments and the scarcity in the market of specified pools. To avoid abnormal settlements, the Department reiterates that any buy- in accomplished pursuant to these rules would be allowed to settle on the next regularly scheduled settlement date for that particular class or pool of mortgage- backed securities.

The Department understands that the PSA will implement buy-in procedures for mortgage-backed securities similar to those in place for other government securities. We believe that reliance on procedures that are already familiar to the broker-dealers should facilitate the implementation of this rule and view efforts to standardize the operational procedures as a positive step.

B. Buy-Ins for Customer Sell Orders

The Department's proposed rules included a requirement to. buy-in customer sell orders (other than a short sale) in cases where the government securities broker or dealer had not obtained the securities from the customer within ten business days after the settlement date. For registered government securities brokers and dealers the Department was proposing to add paragraph 403.4(1) which incorporated by reference paragraph (m) of SEC Rule 15c3-3 (17 CFR 240.15c3- 3(m)), with one modification pertaining to the definition of a short sale. This rule has been suspended by the SEC with respect to exempted securities since 1973, including government securities. A companion buy-in rule for customer sell

orders that would apply to financial institutions that are required to file notice as government securities brokers and dealers was also proposed in April 1991 by adding new paragraph 403.5(g) to the GSA regulations.

In its comment letter, the PSA stated that the ten-day buy-in rule for customer sell orders should not be adopted because it has minimal customer protection benefits. The PSA noted that improvements in the settlement processes and the fact that most Treasury, agency and government mortgage-backed securities are now in book-entry form have resulted in increased deliveries and fewer overall fails. For those few fails that may still occur, the PSA stated that "[b]roker-dealers have business incentives to clean up fails to limit their market exposure." For mortgage-backed securities, the ten-day buy-in time frame would be problematic since it would require delivery of securities outside of the regularly scheduled settlement cycles. The PSA suggested that, if Treasury believes a buy-in rule for customer sell orders must be adopted, the time frame should be consistent with the applicable buy-in time frames for fails to receive.

The Department continues to believe that buy-in rules for customer sell orders are needed to strengthen customer protection because a customer's failure to deliver a security to an executing broker or dealer could result in that broker's or dealer's failure to deliver to another counterparty. Further, these rules will prevent customers from taking advantage of market fluctuations by refusing to deliver a security to a broker or dealer when the price rises after a sell order has been executed.

In response to the comments made by the PSA, the Department is revising the buy-in time frame for customer sell orders in new paragraphs 403.4(l) and paragraph 403.5(g), applicable to registered government securities brokers-dealers and financial institution government securities broker-dealers, respectively, from ten business days to 30 calendar days for all government securities, except mortgage-backed securities, and to 60 calendar days for all government mortgage-backed securities. These time frames are consistent with the buy-in requirements for fails to receive addressed above. The Department also modified the customer sell order rules to permit the use of alternatives other than purchasing securities (e.g., securities may be borrowed, substituted or bought back) in closing out orders. Again, this is consistent with the buy-in rules for fails to receive.

The buy-in rules for customer sell orders continue to provide an exemption for short sales, which are the primary cause for non-deliveries. This should significantly reduce the number of fails subject to these requirements. Similar to buy-ins of mortgage-backed securities that are in a fail to receive status, broker-dealers will be allowed to effect buy-ins for customer sell orders of mortgage-backed securities at the next regularly scheduled settlement cycle.

Finally, the Department is also adopting without change redesignated paragraph 403.5(h), which will now grant the appropriate regulatory agencies for financial institutions the authority to extend the 30- and 60- calendar day time frame for buy-ins of customer sell orders if a financial institution broker-dealer requests an extension. No comments were received on this provision.

C. Effective Dates

The final rules become effective April 29, 1994. This will provide sufficient time for all government securities brokers and dealers to become acquainted with the new requirements and to implement operating procedures. Additionally, the lead time will enable the PSA to finalize and distribute buy-in procedures it is developing for the industry.

In its comment letter, the PSA requested that the Treasury's buy-in rules be enacted contemporaneously with the Commission's amendments to Rule 15c3—3(d)(2) and (m). Since Treasury's rules apply to all government securities brokers and dealers, and given the Department's understanding that the buy-in rules to be proposed by the Commission will conform to those adopted herein, the Department believes that there is no compelling reason to defer implementation until the Commission acts.

III. Special Analysis

The Department has determined that this action does not constitute a "significant regulatory action" for the purposes of Executive Order 12866 (58 FR 51735, October 4, 1993).

Accordingly, it was not subject to review under the Executive Order by the Office of Information and Regulatory Affairs, Office of Management and Budget.

In the preamble to the proposed rules, the Department certified that these amendments would not have a significant economic impact on a substantial number of small entities. Accordingly, a regulatory flexibility analysis was not prepared. In reviewing the final rules being adopted herein and after considering the comments received on the proposed rules, the Department has concluded that there is no reason to alter the previous certification that these rules will not have a significant economic impact on a substantial number of small entities.

Since these final rules contain no new collections of information, the requirements of the Paperwork Reduction Act (44 U.S.C. 3504(h)) are inapplicable.

List of Subjects in 17 CFR Part 403

Banks, Banking, Brokers, Government securities.

For the reasons set out in the Preamble, 17 CFR part 403 is amended to read as follows:

PART 403—PROTECTION OF CUSTOMER SECURITIES AND BALANCES

1. The authority citation for part 403 is revised to read as follows:

Authority: Sec. 101, Public Law 99-571, 100 Stat 3209; sec 4(b), Public Law 101-432, 104 Stat 963; sec. 102, sec 103, Public Law 103-202, 107 Stat 2344 (15 U.S.C. 78o- 5(b)(1)(A), (b)(4)).

2. Section 403.1 is revised to read as follows;

§ 403.1. Application of part to registered brokers and dealers.

With respect to their activities in government securities, compliance by registered brokers or dealers with § 240.8c-l of this title (SEC Rule 8c-l), as modified by §§403.2 (a), (b) and (c), with § 240.15c2-l of this title (SEC Rule 15c2—1), with § 240.15c3—2 of this title (SEC Rule 15c3-2), as modified by § 403.3, and with § 240.15c3-3 of this title (SEC Rule 15c3-3), as modified by §§403.4 (a-d), (e)(2)—(3), (f)-(i), and (1), constitutes compliance with this part.

3. Section 403.4 is amended by revising paragraph (g) and by adding new paragraph (l) after paragraph (k) to read as follows:

§ 403.4. Customer protection— reserves and custody of securities.

(g) For "the purposes of this section, § 240.15c3—3(d)(2) of this title is modified to read as follows:

"(2) Securities included on its books or records as failed to receive more than 30 calendar days, or in the case of mortgage-backed securities, more than 60 calendar days, then the government securities broker or government securities dealer shall, not later than the business day following the day on which such determination is made, take prompt steps to obtain possession or control of securities so failed to receive through a buy-in procedure or otherwise; or"

(l) For purposes of this section, the suspension of § 240.15c3-3(m) of this title (38 FR 12103, May 9, 1973) is no longer effective and the paragraph is modified to read as follows:

"(m) If a government securities broker or government securities dealer executes a sell order of a customer (other than an order to execute a sale of securities which the seller does not own, which for the purposes of this paragraph shall mean that the customer placing the sell order has identified the sale as a short sale to the government securities broker or dealer) and if for any reason whatever the government securities broker or government securities dealer has not obtained possession of the government securities, other than mortgage-backed securities, from the customer within 30 calendar days, or in the case of

mortgage-backed securities within 60 calendar days, after the settlement date, the government securities broker or government securities dealer shall immediately thereafter close the transaction with the customer by purchasing, or otherwise obtaining, securities of like kind and quantity. For purposes of this paragraph (m), the term "customer" shall not include a broker or dealer who maintains a special omnibus account with another broker or dealer in compliance with section 4(b) of Regulation T (12 CFR 220.4(b)).

4. Section 403.5 is amended by revising paragraph (c)(l)(iii); by redesignating paragraph (g) as paragraph (h) and revising newly redesignated paragraph (h); and by adding new paragraph (g) to read as follows:

§403.5. Custody of securities held by financial institutions that are government securities brokers or dealers.

(c)(1)

(iii) Take prompt steps to obtain possession or control of securities failed to receive for more than 30 calendar days, or in the case of mortgage-backed securities, for more than 60 calendar days; or

(g) If a financial institution executes a sell order of a customer (other than an order to execute a sale of securities which the seller does not own, which for the purposes of this paragraph shall mean that the customer placing the sell order has identified the sale as a short sale to the financial institution) and if for any reason whatever the financial institution has not obtained possession of the government securities, except mortgage-backed securities, from the customer within 30 calendar days, or in the case of mortgage-backed securities within 60 calendar days, after the settlement date, the financial institution shall immediately thereafter close the transaction with the customer by purchasing, or otherwise obtaining, securities of like kind and quantity.

(h) The appropriate regulatory agency of a financial institution that is a government securities broker or dealer may extend the period specified in paragraphs (c)(l)(iii) and (g) of this section On application of the financial institution for one or more limited periods commensurate with the circumstances, provided the appropriate regulatory agency is satisfied that the financial institution is acting in good faith in making the application and that exceptional circumstances warrant such action. Each appropriate regulatory agency should make and preserve for a period of not less than three years a record of each extension granted pursuant to this paragraph, which contains a summary of the justification for the granting of the extension.

Dated: February 14, 1994. Frank N. Newman, Under Secretary for Domestic Finance.